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Rea, Samuel

Statement of
Mr. Samuel Rea...

[Philadelphia?]


[1917]

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**STATEMENT OF MR. SAMUEL REA
PRESIDENT, PENNSYLVANIA RAILROAD SYSTEM**

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Box 47*

**BEFORE THE
INTERSTATE COMMERCE COMMISSION
MAY 7, 1917**

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**IN THE MATTER OF THE
APPLICATION OF THE RAILROADS FOR
INCREASED FREIGHT RATES**

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BEFORE THE
Interstate Commerce Commission
MAY 7, 1917

In the Matter of the Application of the Railroads
For Increased Freight Rates

Mr. Samuel Rea, President of the Pennsylvania Railroad System, addressed the Commission as follows:

It is absolutely essential that the railroads be granted higher rates, and as will be clearly shown hereafter, the increase of rates asked for, will not be sufficient to enable the Pennsylvania System to meet the increased expenses now in sight. The railroads are compelled to request an advance in rates because they are suffering from increased costs and taxes, and an inadequate property investment return for at least the five years preceding 1916, and consequently from insufficient credit. In addition, there has been such an extraordinary increase in costs since the closing months of the calendar year 1916, that we are convinced that if we are to adequately handle existing traffic and be prepared to meet the necessities of the international situation, it is absolutely essential that the railroads be granted higher rates. Therefore the conditions surrounding the railroads at the present time involve a direct and immediate menace to the country at

large, and also to the shippers, passengers and owners of the properties because of inadequate facilities and insufficient credit.

That the situation on the Eastern Railroads generally, when all of their equipment and facilities are worked to their maximum, is of serious concern, can be seen from an examination of the figures of the Pennsylvania Railroad System.

It has a peculiarly favorable location, running through a territory rich in natural resources, with a great density of traffic by reason of having the largest and most available traffic centres located on its lines, and supplemented by the freight and passenger business which it receives as a link in the transcontinental systems and from other important railroad connections of the country.

The Pennsylvania System is largely undercapitalized. It has from its origin had a continuously conservative management, which has maintained an unvarying policy of applying a substantial portion of its earnings to betterments, over two hundred millions of which (having been spent prior to 1907) are not included in the property investment account. The System represents a cash investment of One Billion seven hundred million dollars spent for Road and Equipment.

The Pennsylvania System has never paid more than a very moderate return on its investment, less

in fact than the general run of investments in the United States, such as those in manufacturing and mining, and the results of the constant increase in the business of the System have been distributed to the public either through reductions in rates, increases in amounts paid for wages and material, reinvestments in property not capitalized, or by furnishing a progressively better service.

The Pennsylvania System, like the other eastern railroads, finds itself confronted with an immediate necessity for higher rates, in that a very conservative estimate shows that expenses of the Pennsylvania System will be very materially increased over those of 1916. The following is an estimate of the chief items:—

| Pennsylvania System (per annum) | | |
|--|---|----------------------------------|
| | Estimate submitted March 22, 1917 | Revised Estimate May, 1917 |
| Fuel..... | \$10,200,000 | \$15,099,000 |
| Materials (specific items only)..... | 11,000,000 | 14,694,000 |
| Wages—Adamson Law..... | 13,500,000 | 10,757,000 |
| Wages—adjustment for employees other than trainmen..... | 7,400,000 | 10,842,000 |
| Taxes (Federal Capital Stock Tax only)..... | 500,000 | 500,000 |
| | <u>\$42,600,000</u> | <u>\$51,892,000</u> |

I have had the estimate of increased expenses furnished to the Commission on March 22nd, 1917, checked very carefully and revised since then, so that it is based upon actual conditions including price changes in fuel and certain items of ma-

terials and additional expenses effective since that date. The \$14,694,000 for materials is conservative as it affects only about 44 per cent. of the total materials consumed, on which we now have accurate data, but nothing is included for the remaining 56 per cent. The increase, therefore, should be well in excess of \$14,694,000. The increase in wages on account of the Adamson Law has been computed from the January payrolls, on which payments have been made, or are now being made. Later on, I will explain these revised estimates in detail, but I feel assured that our increased expenses and taxes compared with 1916 will certainly exceed \$51,892,000.

Practically no very substantial portion of these increases became effective until on and after January 1st, 1917. The figures for the calendar year ending December 31st, 1916 (which year has recently been adopted by the Interstate Commerce Commission and for which figures are filed in this case), shows that for that year Pennsylvania Railroad System after Sinking Fund payments of \$6,457,571 and average dividends of 6.26 per cent. had remaining a Surplus of \$36,700,000 or 2.90 per cent. on the total capital obligations in the hands of the public. It will readily be seen that the minimum increases in these five expense items alone of \$51,892,000 would not only wipe out the entire Surplus, but cut into the Sink-

ing Fund payments and dividends to the extent of \$15,200,000.

Even if confronted by that condition it would to my mind be an unwise policy to curtail maintenance and replacement expenses, a policy which the Commission has already emphasized as contrary to the public interests. Therefore application is made for an increase in rates, realizing also that future capital expenditures are necessary for which a sound credit basis must be maintained.

During the last seven months (September, 1916—March, 1917, inclusive) even with an increase of \$17,500,000 in total operating revenues, the large increase in operating expenses and taxes has not only more than absorbed the increase in operating revenues, but has actually caused a decrease in net operating income of \$12,400,000, or 22 per cent. as compared with the corresponding period of the previous year.

It is of great significance that this increase in total operating revenues, which represents an increase in the earnings of every month except February, should be accompanied by a decrease in net in every month, notwithstanding the fact that the expenses for these seven months include only to a very limited extent the increase in wages, fuel, material, taxes, etc., the full force of which is just commencing to be felt.

It is also requisite to make a brief review of a few years prior to 1916 to reveal the full force of the present situation. When the last application for an advance in rates was made the Commission found (July, 1914), "that the net operating income of the railroads in Official Classification Territory, taken as a whole, is smaller than is demanded in the interest of both the general public and the railroads." (Five Per Cent. Case, 31 I. C. C., page 384.)

It appeared in that case that the net operating income of the Pennsylvania Railroad System had only increased \$11,860,000 as between 1903 and 1913, or a return of 2.23 per cent. on the increased investment in Road and Equipment of \$530,000,000 made during the ten year period. Comparing 1913 with 1910, it was found that there was an actual decrease of over \$11,000,000 in net operating income, notwithstanding an increase of \$207,000,000 in the investment in Road and Equipment.

The operating revenues of 1913 were, up to that time, the greatest in the history of the System. The investment in Road and Equipment in the ten years, 1903-1913, before referred to had secured an enormous increase in yards, tracks and other facilities. The tractive power of locomotives was increased 80%, the capacity of freight cars 62%, with a corresponding operating effici-

ency reflected in an increase of freight train load (33%) and car load (22%), freight traffic density (61%), and revenue ton mileage (70%) at the expense of only a small increase in freight train mileage (28%). Notwithstanding these facts, the Company found itself much worse off so far as its final results were concerned, than it was in 1900, when the country was emerging from a severe and extended period of financial, commercial and industrial depression.

In its second opinion (December, 1914), in the Five Per Cent. Case (32 I. C. C. 325), the Commission, in speaking of the fiscal year 1914, said (page 328):—

"From whatever comparative standpoint viewed, the net operating revenues of the last fiscal year must be regarded as unduly low."

The position of the Pennsylvania System on June 30th, 1914, was in entire accord with the statement of the Commission, for compared with 1913, there was a decrease of \$12,500,000 in total operating revenue for 1914 accompanied by a decrease of \$11,000,000 in net operating income. This undesirable situation did not end there.

The year 1915 showed a further decrease in total operating revenue being \$27,000,000 below 1914 and a decrease in net operating income of \$1,400,000 below 1914, resulting in the lowest

percentage of return (4.33%) on Road and Equipment of any year of the last seventeen.

This further decrease in net operating income was limited by the elimination, forced upon the Company, of a number of freight and passenger trains, by the large reduction in the number of its employees, in the purchase of less material, and a general curtailment in all departments.

Naturally the year ending June 30th, 1916, compared with such unfavorable conditions in 1915—the worst year of the last seventeen—reflected an extraordinary increase in business. The freight revenue of the Pennsylvania System increased \$58,700,000, the passenger revenue increased nearly \$8,000,000, and the total operating revenues increased over \$72,000,000, which after taking care of increases in expenses of nearly \$30,000,000, gave an increase over 1915 in net operating income of \$40,000,000 and yielded a return of 6.86% on the property investment.

The year ended June 30th, 1916, was the first really good year that the Pennsylvania System has had since 1910. In every year between these two the return on Property Investment has been less than for any year in the period between 1900 and 1910. Our returns on Property Investment from 1900 to 1910, averaged 7.20 per cent., from 1911 to 1916 they averaged 5.40 per cent.; and from 1913 up to and including 1916 the average

was but 5.30 per cent. For the years 1914, 1915 and 1916 the average return was 5.24 per cent., and for 1915 and 1916 it was but 5.61 per cent.

The favorable tendencies of the year ended June 30th, 1916, when we had the benefit of the comparatively low prices of material previously contracted for, continued to exist through July and August of that year, both of which months show not only substantial increases (approximating \$6,000,000, in each month) in total operating revenues, but also increases in net operating income of \$1,290,000 (July), and \$1,435,000 (August).

Since that time, however, a significant change has taken place in the situation. In the nine months since June 30th (which include the favorable months of July and August above referred to), with an increase of \$29,637,000 in total operating revenues, increases occurring in every month except February,—there has been a decrease in Net Operating Income of \$9,716,000 caused largely by an increase of \$21,400,000 in Transportation Expenses. It must also be remembered in considering these figures that payments for increased wages under the Adamson Law, and the increased wages to other classes of employes, both of which have been in force since January 1st, are only included for three months in this period, and while this decrease in net operat-

ing income for the nine months, is serious enough in itself, it will be further intensified in the future by the increased expenses under the Adamson Law—other wages, fuel, material and taxes, only a small portion of which are included in the present income statements.

In other words, we are in even a worse situation than we were in 1913, when for a number of years there had been a continuous increase in operating revenues, but on account of the increased property investment to provide more facilities and equipment, there had been a steady decrease in the return on Property Investment.

The Commission in the 5 per cent. case (32 I. C. C. 325) in speaking of the fiscal year of 1914 said:

“Operating costs and operating revenues fail to show the tendency to such concomitant variation as should prevail in the transportation industry. While the gross revenue in that year declined only about 3.4 per cent., the net revenue shrank approximately 17.7 per cent. as against the previous fiscal year. The indication is that some important items of cost have become relatively inelastic, and that a fall in gross revenue leaves an increasingly narrow margin of net revenue.”

In 1914 we had a decrease in gross unaccompanied by a corresponding decrease in cost, be-

cause as the Commission said, “some important items of cost have become relatively inelastic.”

In 1917 we have substantially increasing operating revenues, but our operating costs have ceased to be inelastic in that they have expanded substantially upward and have much more than absorbed the additional revenues received. In other words, the experience of the last few years would seem to show that so far as many items of railway costs are concerned, they increased more than relatively with an increase in operating revenue, but do not decrease relatively with the decrease in operating revenue.

Since June 30th, 1916, there has been a substantial percentage increase in the number of tons and passengers handled per car and per train compared with same period of previous year which ought to have meant an increase in net operating income. However, the saving that should have been effected thereby was nullified by the increased prices of materials, increased wages, the expense incident to congestion (which became so acute during the last quarter of 1916,) and the reduced efficiency of labor owing to the inability of the railroads to retain their employes in competition with industrial concerns. The latter in periods of business activity can maintain or increase their profits by increasing the price of their products when the increased cost of manu-

facture overtakes them. They are able to and do pay increased wages, to secure and retain competent labor.

It would seem to be to the interest of the shipper to bear an increase in rates in order that he might be taken better care of in time of industrial activity by our being in a position to provide for these maximum demands.

In prosperous times, industries, including those from whom the railroad company makes its purchases, make very material advances in the prices of their products. The increase of prices by manufacturers and producers, means that the railroad company in purchasing from them its material and fuel, has to bear the burden of these increased prices in addition to large increases in wages, taxes, &c., *without being able to recoup itself in any way*, unless it can obtain increased rates.

The inability of a railroad company to increase the price of its product (transportation) prevents it in many cases from meeting the higher rates of wages paid by industrial concerns, and it is unable, therefore, to retain in its service, the experienced employes so essential for efficiency and economical operation. Even with the increases in wages which have already been granted, changes in the force are constantly occurring which necessarily decrease the effi-

ciency of the employes as a whole and means a loss of money and effort to train new men.

To illustrate the unrest and changes in railroad employes the records of the Pennsylvania Lines East show an average number of employes during 1916 of 146,438. The number of new employes was 121,447.

The facts with respect to the various items of prospective expense are as follows:—

WAGES.

We have estimated (based on actual calculations made on the January payrolls for which payments have been made or are now being made), that the increased wages under the Adamson Law would amount to \$10,757,000 for the System, and cover only payments to the enginemen, firemen, conductors, brakemen and hostlers.

Increases to other employes (receiving less than \$300 per month) such as track laborers, carpenters, masons, shopmen, engine-house men, station agents, laborers and mechanics, clerks, telegraphers and other classes of employes which were not effective in 1916 or only partially effective, will amount to at least \$10,842,000 per annum. Since the original estimate of \$7,400,000 was made it has been necessary to increase our

trackmen, involving an annual expenditure of \$2,000,000 and there were some other increases made late in 1916 which will mean an increased annual payment over that made in 1916 of \$976,000.

These increases are necessary to retain our station agents, clerks, skilled mechanics and laborers against the higher wages and competition of industrial establishments.

INCREASED PRICES OF MATERIALS AND SUPPLIES.

There has been a constant and still continuing increase in the prices of materials and supplies, which has increased the operating expenses since the latter part of the calendar year 1916 on account of the expiring of contracts made at lower prices, and the necessity for purchases at much higher figures than had previously prevailed.

These increasing prices are not confined to any particular item used in railroad operation, but include all materials, the principal items of which (Lines East) have increased some 70 per cent. in cost over the average prices paid in 1916. For example: axles have advanced 125 per cent., steel bridge material 119 per cent., steel plates 188 per cent., tie plates 102 per cent., castings 122 per cent., while the prices

now submitted for rails is \$40 a ton instead of \$30, and the cost of equipment has risen in the last year some 50 per cent.

As illustrating the large increases in the prices of iron and steel articles, a contract was recently made by the Pennsylvania Railroad Company for 10,000 tons of steel plates at a price of \$110 per ton. The same material was purchased in March, 1916, for \$47 per ton.

Our Lines West of Pittsburgh were asked by the Commission in the Lake Cargo Case to file certain statements on forms approved by the Commission showing the increase in material prices over 1916. This statement has been filed and an additional statement has been made up along the same lines for the Lines East. These exhibits cover only about 44 per cent. of the material purchased in 1916, and the increase in the prices thereof was shown to be 59.36 per cent.

A very conservative estimate of the amount of materials included in Operating Expenses for 1916 is \$56,261,223. The increase of 59.36 per cent. on 44 per cent. thereof alone, which is the portion for which we have accurate data, would amount to \$14,694,531. This, of course, is a minimum increase as we know there will be substantial increases in the balance of 56 per cent., on which we have allowed for no increase, so that it is safe

to say the increase will be well above the minimum stated.

FUEL SUPPLY.

The fuel supply of the Pennsylvania System during 1916 was 18,335,489 of which 11,749,194 tons went to the System East and 6,586,295 tons to the System West.

The fuel contracts for the Lines East expired on April 1st, 1917, and so far we have only secured a part of our supply and at largely increased prices, which with some allowance for the increased wages of coal miners, will average a minimum increase of 90 cents per ton.

Pennsylvania Lines West have recently made contracts for their entire yearly fuel supply of over 6,000,000 tons of which 5,000,000 tons have been arranged for on contracts which run for three years and the balance of the contracts for one year. The price will average after making some allowance for the increased cost of wages of coal miners, a total minimum increase for the Lines West of 68 cents per ton.

Each contract contains a clause increasing the price if any advance in wages of the coal miners takes place. This estimate of added cost is the minimum cost and is based upon contracts made and assuming that the balance of our sup-

ply will be purchased at the same price, but this is not true for the reason that coal which we have purchased in the open market to eke out our supply is costing us from \$2.50 to \$5.00 per ton.

Based upon the consumption of 11,749,194 tons on the System East, the increase at 90 cents per ton would aggregate \$10,621,000, while the consumption of 6,586,295 tons on the System West at an increase of 68 cents would aggregate \$4,478,000, or a total average increase for the System of 82 cents per ton or \$15,099,000.

When an estimate as to increased cost on account of fuel supply was presented to your Commission on March 22d, 1917, it was estimated that our increase on the System would be about 56 cents per ton or \$10,200,000, but as I have indicated, we were disappointed.

Though we all hope that the present prices of iron and steel, other material and fuel will not continue, yet there is nothing in the present outlook which would justify us, in deferring to make our contracts for fuel and for materials required for repairs and replacement work, nor to warrant the assumption that there will be a substantial reduction in labor or material prices at any time in the near future. So far as can be foreseen the present shortage of labor and demand for material is likely to exist for a long time in the future.

EFFECT OF THE PROPOSED RATE INCREASE ON THE
REVENUES OF THE PENNSYLVANIA SYSTEM.

All of the foregoing justifies the view that higher rates are necessary to meet higher costs and taxes and maintain a sound credit basis.

The results for the year ending June 30th, 1916, the year of largest operating revenue, are extremely favorable when compared with the year of 1915, but it should be remembered that 1915 had the lowest return on property investment for any year since the depression existing before 1900 and the lowest net operating income since 1904 although between 1904 and 1915 almost \$600,000,000 additional had been spent on the property.

Using as a basis the results of the year ending June 30th, 1916, if we assume that our net operating income will decrease only by the amount of the estimated increase in fuel, wages, materials and taxes already stated, namely, \$51,892,000 (which is a conservative assumption in view of the present results and those immediately prospective) then this increase in expenses alone will more than wipe out the entire surplus of the System, and will result in earning only about $3\frac{1}{2}$ per cent. on the property investment. This return would not only be entirely inadequate, but it is also absolutely impossible to operate and finance a large System like ours on any such basis.

We have estimated that if the entire 15 per cent. be allowed on all traffic other than bituminous coal, coke and ore, and that the specific increases on all that traffic be also realized, that we will secure approximately an increase of 13.30 per cent. of our freight revenue, or \$39,578,622 and that we will still be \$12,300,000 worse off than we were in 1916.

The year 1916 has reinforced the experience of former years that our rates have not been high enough to produce a sufficient surplus and credit basis to justify us in providing facilities (notwithstanding an expenditure of \$700,000,000 for Road and Equipment since 1900) far enough ahead to adequately take care of the progressive demands of our transportation business, and it is just in times like last year, that such facilities are most vitally needed.

For example; the ton mileage of the Pennsylvania Railroad System doubles every ten or twelve years, and it is essential that this System should expend an average of at least fifty millions of dollars per annum for Road and Equipment, to take care of the increasing business of the System.

The financial results of the System for the year ending June 30th, 1915 (when costs of labor and material were reasonable) only enabled it to expend seventeen millions of dollars for Road and Equipment, and it is factors such as that

which have in part caused the congestion existing in the last year in the railroad facilities of the country.

The extraordinary increased prices of materials and labor with the narrow margin of earnings have already compelled us to defer, temporarily, I hope, new construction work for much needed facilities aggregating on the Lines East of Pittsburgh \$16,000,000 in amount, but it is essential that these and many other improvements shall be made in order to adequately handle the business of the country, governmental and otherwise. The country's activities should not be restrained, but expanded under existing conditions.

I feel therefore that the increased rates asked for are absolutely necessary from the standpoint of the railroads and country, entirely aside and apart from the present international crisis. But the war in which we are now engaged so intensifies the need of keeping the railroads in a stable and prosperous condition, both physically and financially that I feel it is absolutely essential to the welfare of this country and to the business we serve, that the Pennsylvania System as well as other railroads, be promptly put in a position where they can continuously provide and maintain an adequate transportation service. This cannot be done properly on present rates for transportation.

There is at the present time, and there will be for sometime, a widespread and pressing demand for larger terminals, increased facilities, more equipment, and for the extension and improvement of existing facilities, and if the railroads are to be able to attract new capital for these facilities, they will have to be in a position in which they can meet the rising cost of operation, and thus have the necessary earning basis to attract new capital.

If the railroads are not put in this position, it means that for to-day, and for many years in the future, there will be a further substantial curtailment of expenditures for improvements and facilities, notwithstanding the fact that this is the period of the greatest demand for railroad transportation service—passenger and freight—that this country has ever known.

The public expects us to provide facilities to meet rapid increases in traffic and it is clearly to the public benefit that we should be able to do this, but the lack of sufficient surplus for many years past, has prevented the railroads from providing such additions and improvements in advance of traffic demands while labor and material costs were reasonable.

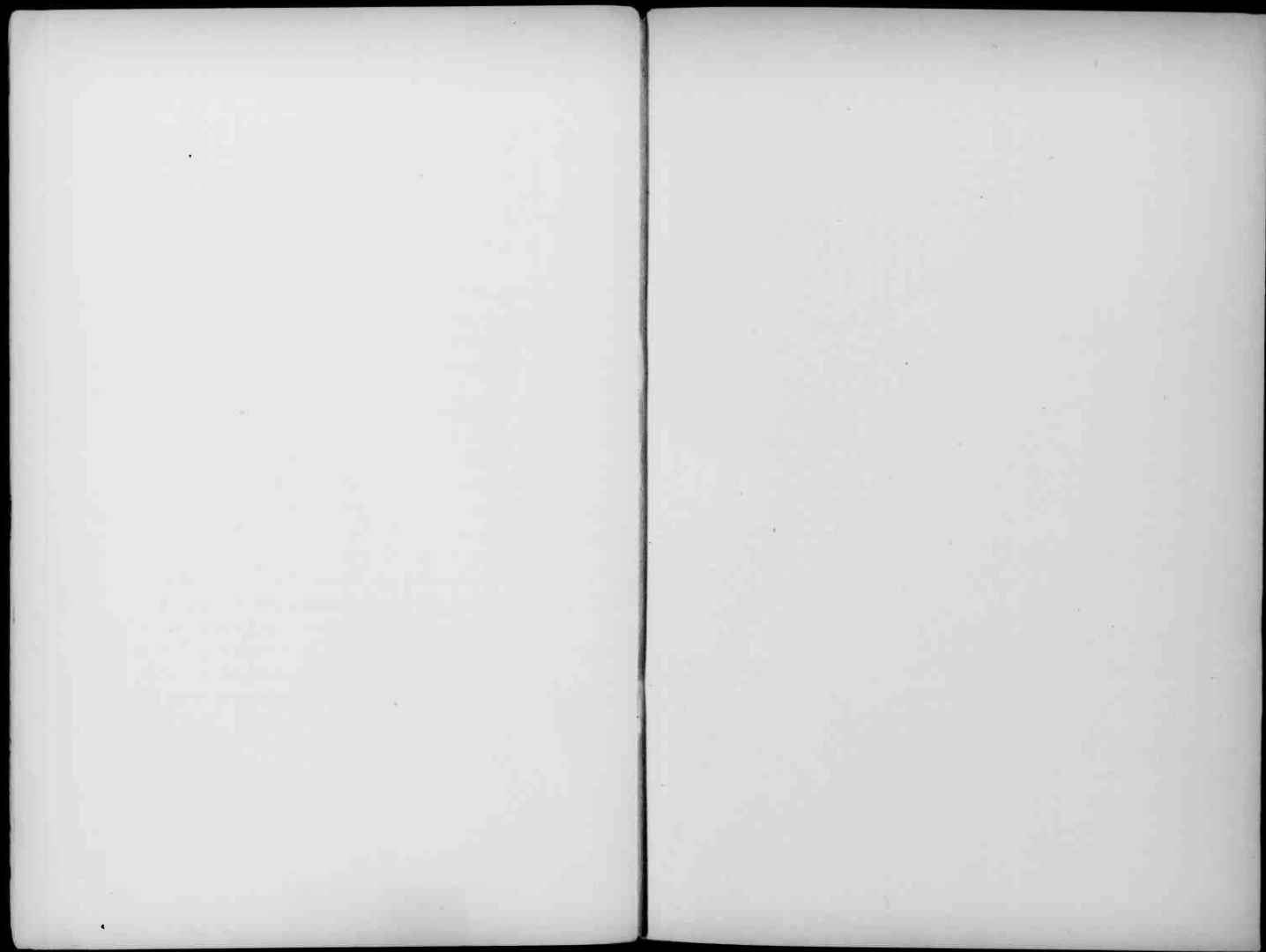
If the railroads are to provide the facilities and handle the business of the country and its food and fuel supply with that expedition which pres-

ent necessities demand, and if they are to give that preference to Government and other special traffic which they must and will give, and move the same with that expedition which will be so imperatively demanded, it is absolutely essential that they shall be provided with the additional revenues.

The railroads have signified their intention, to render the Government any assistance in connection with the prompt and expeditious handling of troops and supplies which it may require and are now making the same effective.

They are also endeavoring to specially facilitate the transportation of food, fuel and raw materials for public needs, and to perform this service with the utmost efficiency and energy possible. But so that the efforts of the railroads may not be handicapped they must be in a position to adequately operate and maintain their property, and provide the facilities so urgently demanded.

Existing international emergencies and exceptional industrial activity demonstrate the importance of having all the railroads in the strongest financial condition, much stronger than they are at the present time. This result cannot be secured except by permitting the advanced rates to go into effect at the earliest possible moment.



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